[JOINT COMMITTEE PRINT]

BACKGROUND ON CLASSIFICATION OF EMPLOYEES AND INDEPENDENT CONTRACTORS FOR TAX PURPOSES AND DESCRIPTION OF S. 2369

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

SENATE COMMITTEE ON FINANCE

ON

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INTRODUCTION

The Senate Finance Subcommittee on Oversight of the Internal Revenue Service has scheduled a public hearing on April 26, 1982, on S. 2369 (Senators Dole, Danforth, Boren, Wallop, Symms, Roth, Johnston, Kassebaum, Laxalt, Durenberger, and Hatch), relating to the tax status of independent contractors and tax compliance in the independent contractor sector.

This pamphlet, prepared in connection with the hearing, is divided into four parts. The first part is a brief summary of present law, background, and S. 2369. The second part is a discussion of present law. The third part discusses the background of the independent contractor/employee issue which led to legislative proposals. This part includes a discussion of the interim relief provided by the Revenue Act of 1978, and subsequently extended through June 30, 1982. The fourth part provides a description of the provisions of S. 2369.

I. SUMMARY

A. Present Law

Determination of status

Under present law, the classification of particular workers as employees or independent contractors for Federal income and employment tax purposes generally is determined under common law (i.e., nonstatutory) rules. Under the common law, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished," the relationship of employer and employee exists.

Social Security (FICA) taxes

For the calendar year 1982, employers and employees are required by the Federal Insurance Contributions Act to pay social security (FICA) taxes of 6.70 percent each on the first $32,400 of the employee's wages, for a maximum of $2,170.80 each and a maximum of $4,341.60 per employee.

Federal Unemployment Tax Act (FUTA) taxes

The FUTA tax is levied on covered employers at a current rate of 3.4 percent on wages up to $6,000 per year paid to an employee. However, a 2.7 percent credit normally is provided to employers who pay taxes under approved State unemployment compensation programs.

Federal income tax withholding

In addition to the responsibility for FICA and FUTA taxes, an employer who pays wages to an employee must withhold for each pay period a portion of the wages to satisfy all, or part, of the employee's Federal income tax liability.

Taxes on self-employed individuals

Compensation paid to individuals who are self-employed is not subject to Federal income tax withholding. Rather, self-employed individuals generally must make quarterly payments of estimated income and self-employment taxes directly to the Treasury.

For calendar year 1982, self-employed individuals with net self-employment earnings of $400 or more are required by the Self-Employment Contributions Act to pay social security (SECA) tax of 9.35 percent on earnings up to $32,400, for a maximum SECA tax of $3,029.40. Self-employed persons are not subject to FICA or FUTA taxes.

B. Background of Legislative Proposals

Increased IRS enforcement

In the late 1960's, the Internal Revenue Service increased audits of employment taxes. As a result, controversies developed between the

Service and some businesses concerning the proper classification of workers, including insurance agents, direct sellers, and real estate agents.

If a worker who had been treated as an independent contractor by a business were reclassified as an employee for past pay periods, the business would become liable for employment taxes (withholding, social security, and unemployment) with respect to the reclassified worker.

Revenue Act of 1978

The Revenue Act of 1978 provided interim relief for certain businesses involved in employment tax status controversies with the Service. In general, the Act terminated a business' potential liabilities for Federal income tax withholding, social security, and FUTA taxes in cases where the taxpayer had a reasonable basis for not treating workers as employees. In addition, the Act prohibited the issuance of Treasury regulations and revenue rulings on common law employment status.

The interim relief provisions of the 1978 Act, after extensions by Public Laws 96–167 and 96–541, are in effect through June 30, 1982.

C. S. 2369

The bill would provide a statutory "safe-harbor" test under which certain workers would be treated as independent contractors for Federal employment tax purposes; would impose specific information reporting requirements on persons who make payments to independent contractors; would provide new reporting requirements for persons who sell consumer products to buyers for resale in the home; and would provide new penalties for failures to report independent contractor payments. In addition, the bill would impose a withholding requirement in certain situations.

Safe-harbor test

An individual who satisfied the safe-harbor test would be classified as an independent contractor for Federal employment tax purposes. The safe-harbor requirements, each of which would have to be met for an individual to be classified as an independent contractor, relate to (1) control of hours worked, (2) place of business, (3) investment or income fluctuation, (4) written contract and notice of tax responsibilities, and (5) the filing of required returns. An individual who did not meet all five safe-harbor requirements would be classified as an independent contractor or as an employee according to the common law rules.

Information reporting requirements

Under the bill, a specific provision would be added to the Code requiring information returns to be filed by a person for whom services are performed with respect to payments of remuneration, if aggregating $600 or more, to another person in the course of a trade or business. Also, direct sellers who make sales of certain consumer products aggregating $5,000 or more would be required either to file information returns with respect to sales, or to report payments of remuneration aggregating $50 or more. Direct sellers who elect to report pay-

ments of remuneration aggregating $50 or more also would be required to file a return which sets forth the name and identification number of each buyer with respect to whom they had aggregate sales of $50 or more.

Penalties and withholding

The bill would provide new penalties for failures to file information returns or to provide payees with statements. Moreover, withholding would be required in certain situations involving failures by payees to supply identification numbers.

The penalty for failure to file an information return or to furnish the recipient of the payment with a statement would be one percent per month (but not to exceed five percent) of the amount required to be included on the return, or on a statement to the recipient, that was not so included. In addition, a surcharge of 100 percent of the basic penalty amount would be imposed if the number of failures to file an information return, or to furnish statements, represents over 10 but not over 20 percent of the total number of returns and statements required to be made. The surcharge would be 200 percent if the number of failures exceeded 20 percent of the required number of returns and statements.

Finally, the bill would provide for withholding at a 15-percent rate if a worker failed to supply an identification number or supplied an incorrect number to another person who must file a return or furnish statements regarding payments for services or direct sales.

Effective dates

The safe-harbor test generally would apply to services performed after the earlier of June 30, 1982, or the date of enactment.

The new penalties and reporting requirements generally would apply to payments made after 1982; the reporting requirements for direct sales would apply to sales after 1983.

The new withholding provisions would apply to payments made after 1983.

II. PRESENT LAW

A. Classification of Individuals as Employees or Independent Contractors

Overview

Under present law, with certain statutory exceptions,[1] common law (i.e., nonstatutory) rules generally apply to determine whether particular workers are treated as employees or as independent contractors (self-employed persons) for purposes of Federal employment taxes. The determination of whether an employer-employee relationship exists is important because wages paid to employees generally are subject to social security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and to unemployment taxes imposed on the employer under the Federal Unemployment Tax Act (FUTA). Compensation paid to independent contractors is subject to the tax on self-employment income (SECA), but not to FICA or FUTA taxes. (SECA is paid only by the self-employed individual.) In addition, Federal income tax must be withheld from compensation paid to employees, but payments to independent contractors are not subject to withholding.

The Internal Revenue Code generally defines an employee as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."[2] Under the common law test, an employer-employee relationship generally "exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[3] Thus, the most important factor under the common law is the degree of control, or right of control, which the employer has over the manner in which the worker is to perform services for the employer.

Consideration of various factors

In determining whether the necessary degree of control exists in order to find that an individual has common law employee status, the courts and the Internal Revenue Service ordinarily consider a number of factors. No single factor generally is dispositive of the issue.

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[1] Code sec. 3121(d)(3) (relating to statutory employees under the Federal Insurance Contributions Act) establishes four categories of statutory employees: certain agent-drivers or commission-drivers; full-time life insurance salespersons; home workers performing services on goods or materials; and full-time traveling or city salespersons. See also secs. 3306(i) and 1402(d).

[2] Code secs. 3121(d)(2) (FICA), 3306(i) (FUTA), and 1402(d) (SECA).

[3] See Treas. Reg. § 31.3401(c)-1(b).

Instead, all of the facts of a particular situation must be evaluated and weighed in light of the presence or absence of the various pertinent characteristics. The decision as to the weight to be accorded to any single factor necessarily depends upon both the activity under consideration and the purpose underlying the use of the factor as an element of the classification decision. Because of the particular attributes of a specific occupation, any single factor may be inapplicable.

List of factors

The 20 common law factors [4] generally considered in determining whether an employer-employee relationship exists are directed at the following questions:

1. Is the individual providing services required to comply with instructions concerning when, where, and how the work is to be done?
2. Is the individual provided with training to enable him or her to perform a job in a particular manner or method?
3. Are the services performed by the individual integrated into the business' operations?
4. Must the services be rendered personally?
5. Does the business hire, supervise, or pay assistants to help the individual performing services under contract?
6. Is the relationship between the individual and the person for whom he or she performs services a continuing relationship?
7. Who sets the hours of work?
8. Is the individual required to devote full time to the person for whom he or she performs services?
9. Does the individual perform work on another's business premises?
10. Who directs the order or sequence in which the work must be done?
11. Are regular oral or written reports required?
12. What is the method of payment—hourly, weekly, commission, or by the job?
13. Are business or traveling expenses reimbursed?
14. Who furnishes tools and materials necessary for the provision of services?
15. Does the individual performing services have a significant investment in facilities used to perform services?
16. Can the individual providing services realize both a profit or loss?
17. Can the individual providing services work for a number of firms at the same time?
18. Does the individual make his or her services available to the general public?
19. Is the individual providing services subject to dismissal for reasons other than nonperformance of contract specifications?
20. Can the individual providing services terminate his or her relationship at any time without incurring a liability for failure to complete a job?

[4] The common law factors are set forth in the following Internal Revenue Service documents: Exhibit 4640–1, Internal Revenue Manual 8463 and Chapter 2, "Employer-Employee Relationships," Training 3142–01 (Rev. 5–71).

B. Differences in Tax Liabilities Resulting From Classification as an Employee or Independent Contractor

Employees

FICA tax

The Federal Insurance Contributions Act (Code secs. 3101–3126) imposes two taxes on employers and two taxes on employees. These taxes are used to finance the payment of old-age, survivor, and disability insurance benefits payable under Title II of the Social Security Act and to finance the costs of hospital and related post-hospital services incurred by social security beneficiaries as provided in Part A of Title XVIII of the Social Security Act (Medicare).

The FICA tax base is measured by the amount of wages received with respect to employment. The term "wages" generally means all remuneration for employment unless specifically excepted. (Treas. Reg. § 31.3121(a)–1). The term "employment" includes all non-exempt service, of whatever nature, performed by an employee for the person employing him or her (Treas. Reg. § 31.3121(b)–3). An employer must withhold the employee's share of FICA taxes from the employee's wages when paid (secs. 3102 (a) and (b)).

For calendar year 1982, employers and employees are each required to pay FICA tax of 6.70 percent on the first $32,400 of an employee's wages (for a maximum of $2,170.80 each, or a total maximum of $4,341.60 per employee).[5]

FUTA tax

The Federal Unemployment Tax Act (Code secs. 3301–3311) imposes a tax on employers. FUTA tax revenues are used to pay the administrative costs of Federal and State unemployment compensation programs and to help finance the payment of benefits to unemployed insured workers.

The FUTA tax is levied on covered employers at a current rate of 3.4 percent on wages of up to $6,000 a year paid to an employee (sec. 3301). However, a 2.7 percent credit against Federal tax liability normally is provided to employers who pay State taxes under an approved State unemployment compensation program (sec. 3302). For employers in States which have an approved unemployment compensation program, the effective FUTA tax rate normally is 0.7 percent (a maximum of $42 per employee).

The FUTA tax generally applies to an employer who employs one or more employees in covered employment for at least 20 weeks in the current or preceding calendar year or who pays wages of $1,500 or more during any calendar quarter of the current or preceding calendar year. In addition, certain agricultural labor and domestic services constitute covered employment for purposes of the FUTA tax.

Income tax withholding

In addition to the responsibility for FICA and FUTA taxes, an employer who pays wages to individual employees must withhold a portion of the wages to satisfy all, or part, of the employee's Federal income tax liability (sec. 3402).

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[5] The current FICA tax rate is scheduled to increase to 7.05 percent in 1985, 7.15 percent in 1986, and 7.65 percent in 1990.

The definitions relating to employment for purposes of income tax withholding are similar to the FICA and FUTA definitions. The term "employer" generally is defined as any person for whom an individual performs any service as an employee. An "employee" is an individual who performs services subject to the control of an employer, both as to what shall be done and how (Treas. Reg. § 31.3401(c)–1). The term "wages" is defined generally as all remuneration, unless specifically excluded, for services performed by an employee for the employer, including the cash value of all remuneration paid other than in cash (sec. 3401(a)).

Self-employed individuals

SECA tax

The Self-Employment Contributions Act (Code secs. 1401–1403) imposes two taxes on the self-employed. The SECA taxes finance the cost of old-age, survivors, and disability insurance benefits payable under Title II of the Social Security Act, as well as the cost of hospital and related post-hospital services incurred by social security beneficiaries (as provided for in Part A of Title XVIII of the Social Security Act).

The taxes levied under SECA, and the amount of income which may be credited toward benefits or insurance coverage, are based on an individual's self-employment income. The term "net earnings from self-employment" generally means the sum of: (1) the gross income derived by an individual from any trade or business carried on by such individual, less allowable deductions attributable to such trade or business, and (2) the individual's distributive share of the ordinary net income or loss from any trade or business carried on by a partnership of which the individual is a member (Code sec. 1402(a)).

The term "self-employment income" excludes net earnings from self-employment in any taxable year if such earnings are less than $400 (Code sec. 1402(b)).

For calendar year 1982, a self-employed individual must pay SECA tax at a rate of 9.35 percent on net earnings of up to $32,400 (for a maximum SECA tax of $3,029.40).[6] Although the SECA tax rate (9.35 percent) is higher than the rate applicable to an employee's share of FICA tax (6.70 percent), it is lower than the combined employer-employee FICA rate (13.4 percent). An individual with $400 or more of net earnings from self-employment for the year must file a return showing the self-employment tax due (sec. 6017).

Income tax withholding

There is no Federal income tax withholding with respect to self-employment income. A self-employed individual may be required to file a declaration of estimated income tax if his or her gross income for the year reasonably can be expected to include more than $500 from sources other than wages (sec. 6015). However, no declaration is required if the amount of estimated tax for the year is less than $200.[7]

[6] The SECA tax rate currently is scheduled to increase to a rate of 9.90 percent in 1985, 10 percent in 1986, and 10.75 percent in 1990.

[7] The estimated tax payment threshold is scheduled to increase in annual increments of $100 until it reaches $500 for 1985 and subsequent years.

C. Information Reporting

Under present law, persons engaged in a trade or business generally must file information returns with respect to payments to another person aggregating $600 or more in the taxable year (sec. 6041(a)).[8] This reporting obligation, subject to various exceptions, applies to payments (whether made in cash or property) of salaries, wages, commissions, fees, other forms of compensation for services, and other fixed or determinable gains, profits, or income.

These information returns, which are required to be filed on an annual basis, generally must contain the name, address, and identification number of the recipient of the payment, and the aggregate amount paid (secs. 6041(a) and 6109(a)). Recipients covered by this reporting requirement must furnish their name and address to the payor (sec. 6041(c)).

In addition, a payor required to file such an information return with the IRS also must provide the recipient with a statement which shows the payor's name, address, and identification number and the aggregate amount of payments made to the recipient (sec. 6041(d), effective for returns required after 1981).

The penalty for failure to file an information return, or to provide the recipient with a statement, is $10 for each failure, with a maximum aggregate penalty of $25,000 for any one calendar year (sec. 6652(a) and 6678).

D. Judicial Remedies in Employment Tax Disputes

The U.S. Tax Court does not have jurisdiction over disputes involving employment taxes (sec. 6211). Thus, after assessment of an employment tax, the only judicial remedy ordinarily available to a taxpayer is payment of the tax, followed by a refund suit in a U.S. district court or the U.S. Court of Claims (after September, 1982, the U.S. Claims Court).

Since employment taxes are "divisible,"[9] however, a taxpayer generally may challenge an employment tax assessment merely by paying the tax for one worker for one quarter, and then suing for a refund of that tax.[10] Generally, such a refund suit also would include a claim for an abatement of the unpaid. but previously assessed, taxes. The Service ordinarily would counterclaim in the litigation for the balance of the assessment. This procedure allows a resolution of employment tax issues without payment of the full amount of the employment tax assessment prior to litigation.

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[8] Generally, these returns are intended to inform the Internal Revenue Service that specified items have been disbursed by a payor. This information may aid the Service in determining whether the recipient of the item covered by the return has treated it properly for tax purposes. The obligation to file information returns is in addition to the requirement to file returns which reflect the filer's primary liability for the payment of a tax.

[9] That is, they are predicated on the employment of an individual for a calendar quarter.

[10] See, e.g., *Marvel* v. *U.S.*, 548 F. 2d 295 (10th Cir. 1977).

III. BACKGROUND OF LEGISLATIVE PROPOSALS

A. Increase in Controversies Over Employment Tax Status

As a result of increased employment tax audits in the late 1960's, controversies developed between some businesses and the Internal Revenue Service as to whether certain groups or types of workers who had long been treated as independent contractors should be classified as employees for Federal tax purposes. If such workers were classified as employees for past pay periods, then the business would become liable for previously unpaid employment taxes—i.e., social security (FICA) taxes, unemployment (FUTA) taxes, and Federal income tax withholding—for all open years.

Many of these businesses argued that proposed classifications of certain workers as employees involved changes of positions previously taken by the Service in interpreting how the common law rules applied to their workers or industry. One example of what many taxpayers believed to be a controversial change of position involved two 1976 revenue rulings dealing with real estate salespersons. Rev. Rul. 76–136 [1] held that securities and real estate salespersons, remunerated solely on a commission basis, are not employees where, although provided office facilities and supplies, they are required to pay their own expenses and are not required to work under supervision, attend meetings, or work specified hours. Rev. Rul. 76–137 [2] held that real estate salespersons, remunerated solely on a commission basis, are employees of a real estate company where they are registered by the State in the name of the company, may receive a draw against commissions, may be required to submit reports and attend sales meetings, and may be discharged for failure to sell a minimum amount of property. Both of these rulings were revoked in 1978.[3]

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[1] 1976–1 C.B. 312.
[2] 1976–1 C.B. 313.
[3] Rev. Rul. 78–365, 1978–2 C.B. 254.

B. Consequences of Reclassifying Workers

Overview

If a worker who has been treated as an independent contractor is determined retroactively to be an employee, four general tax consequences may follow:

(1) The business whose workers are reclassified may be assessed FICA and FUTA employment taxes for years for which such assessment is not barred by the statute of limitations.

(2) Overpayments of income taxes may occur if the business is required to pay amounts as withholding of employee income tax liabilities with respect to which workers already had paid income tax (through estimated tax payments or with their returns).

(3) Overpayments of social security taxes may occur if the business is required to pay FICA taxes with respect to workers who already had paid self-employment (SECA) taxes.

(4) The retirement plan of the business may be disqualified.

Withholding

If a worker reclassification occurs, the employer generally is responsible for all employment tax liabilities (income tax withholding, both the employer's and the employee's share of FICA taxes, and the FUTA taxes) with respect to the reclassified worker. Federal income tax withholding assessments may be adjusted if the reclassified worker pays (or has paid) the proper amount of income tax (sec. 3402(d)). However, the employer generally is not relieved of any applicable penalties or additions to tax for failure to timely pay over amounts as withholding.

FICA tax

The reclassified worker's share of FICA tax often is not adjusted to reflect the amount of SECA tax already paid on the same income. This is because present law (sec. 6521) authorizes a FICA–SECA offset only if the worker who has been reclassified as an employee is prevented from filing for a refund of the SECA tax paid in error. This may result in the double collection of the employee's portion of social security tax: (1) once from the business as the FICA tax it initially failed to withhold from the reclassified employee, and (2) once from the employee as the SECA tax previously paid in error, if the employee could obtain a SECA tax refund but fails to do so.

Retirement plans

The reclassification also may have adverse effects on self-employed (H.R. 10) retirement plans. If the individual previously had received a determination from the Service that he or she was an independent contractor and then was reclassified as an employee, the retirement plan would be frozen and any future contributions to the plan would

not be exempt from tax. If the individual previously had not received such a determination, the plan could be disqualified and all amounts in the plan (previous contributions plus income) then would be taxable. Furthermore, if an employer previously had established a qualified retirement plan for some workers whose status as employees was recognized, and the Service subsequently reclassified as employees additional workers whom the employer had been treating as independent contractors, the previously qualified retirement plan for the employees could be disqualified for failure to meet the minimum coverage requirements (sec. 410(b)).

C. Tax Reform Act of 1976

The conferees on the Tax Reform Act of 1976 requested that, until completion of a study by the staff of the Joint Committee on Taxation on the problems of classifying workers for tax purposes, the Internal Revenue Service should not apply "any changed position or any newly stated position which is inconsistent with a prior general audit position in this general subject area to past, as opposed to future, taxable years * * *."[4] The Joint Committee on Taxation previously had asked the General Accounting Office (GAO) to examine the Service's administration of employment taxes, including the classification of individuals as employees or independent contractors.

D. GAO Recommendations

In its 1977 report, the GAO concluded that the principal problem with regard to classification of individuals for employment tax purposes is the uncertainty in the interpretation and application of the governing common law rules.[5] Based on its survey of industries and workers, the GAO concluded that uncertainty and controversies most frequently arise in cases in which an individual operates a business that is separate from, or subordinate to, another business that the Service may consider to be the individual's employer.[6]

The GAO recommended that the owner of a separate business entity should be excluded from the common law definition of employee if the owner:

(1) has a separate set of books and records which reflect items of income and expenses of the trade or business;

(2) has the risk of suffering a loss and the opportunity of making a profit;

(3) has a principal place of business other than at a place of business furnished by the persons for whom the owner performs or furnishes services; and

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[4] House Rpt. No. 94–1515, 94th Cong., 2d Sess. (1976), at 489. The Joint Committee staff report, "Issues in the Classification of Individuals as Employees or Independent Contractors" (JCS–5–79, February 28, 1979), provided an explanation of the common law rules governing employment status, a description of the source of employment tax status controversies, and a review of prior Congressional action. The report also discussed some of the interests and concerns of the parties involved in employment tax controversies, and analyzed how present law treats those parties and how several alternatives might affect them.

[5] Report of the Comptroller General to the Joint Committee on Taxation, "Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions," GGD–77–88, November 21, 1977.

[6] Examples of such cases would include sales through an independent agency of another party's products, or the subcontracting of work from a prime contractor.

(4) holds himself out in his own name as self-employed or makes his own services generally available to the public.

An employer-employee relationship would exist, under the GAO recommendations, if an individual met fewer than three of these tests. If an individual met three of the four tests, the common law criteria would be used to determine employment status. The GAO further recommended that, absent fraud, the Service should be prevented from making a retroactive employee determination if the business annually obtains from the workers it classifies as self-employed signed certificates stating that they meet the separate business entity criteria and the business annually provides the Service with the names and employer identification or social security numbers of all certificate signers.

In order to alleviate the problem of double collection of social security taxes on the same income, the GAO recommended that the Service be authorized to reduce the employee portion of FICA taxes assessed against employers by an appropriate portion of the self-employment taxes (SECA) paid by reclassified workers for the open years.

E. Revenue Act of 1978

General rules

During consideration of the Revenue Act of 1978, the Congress decided that it would be appropriate to provide interim relief to taxpayers involved in employment tax status controversies with the Service until the Congress had time to resolve the complex issues involved in that area. Section 530 of the 1978 Act provided such relief by: (1) terminating certain employment tax liabilities for periods ending before January 1, 1979; (2) allowing taxpayers who had a reasonable basis for not treating workers as employees in the past to continue such treatment for periods ending before January 1, 1980, without incurring employment tax liabilities; and (3) prohibiting the issuance, prior to 1980, of regulations and revenue rulings on common law employment status.

The temporary prohibitions on employment tax status reclassifications and on the issuance of new rulings or regulations were extended, by P.L. 96–167, through December 31, 1980. These prohibitions were again extended, by P.L. 96–541, through June 30, 1982.

Prohibition on reclassifications

The 1978 Act allows a business to treat its workers as independent contractors (through June 30, 1982, pursuant to the extensions) unless there is no reasonable basis for that treatment. The taxpayer must file all Federal tax returns (including information returns) that are required to be filed with respect to workers whose status is at issue on a basis consistent with the taxpayer's treatment of the workers as independent contractors.

The 1978 Act established three alternative statutory standards which, if met, provide a reasonable basis for treating a worker as an independent contractor. The first standard is met if the taxpayer's treatment of a worker as an independent contractor is due to reasonable reliance upon judicial precedent, published rulings, technical advice with respect to the taxpayer, or a ruling issued to the taxpayer. The second standard can be met by showing reasonable reliance upon a past IRS audit of the taxpayer. The third statutory method for

establishing a reasonable basis for treating a worker as an independent contractor is to show that such treatment coincides with a long-standing, recognized practice of a significant segment of the industry in which the worker whose status is at issue is engaged.

The three statutory methods for fulfilling the Act's requirement that the taxpayer have a reasonable basis for treating a worker as an independent contractor are not exclusive. That is, a taxpayer may be able to demonstrate a reasonable basis for treating a worker as an independent contractor in some other manner.

Prohibition on rulings and regulations

The Act prohibits the Service from issuing any regulation or revenue ruling that classifies individuals for purposes of employment taxes under interpretations of the common law. However, this prohibition does not apply to the issuance of private letter rulings requested by taxpayers, or of regulations or revenue rulings that do not involve application of common law standards.

IV. DESCRIPTION OF S. 2369

A. Overview

S. 2369 (The Independent Contractor Tax Classification and Compliance Act of 1982) would provide a statutory "safe-harbor" test under which certain workers are treated as independent contractors for Federal employment tax purposes; would impose certain information reporting requirements on persons who make payments to independent contractors; would provide new reporting requirements for persons who sell consumer products to buyers for resale in the home; and would provide new penalties for failures to report independent contractor payments, or to provide required statements to independent contractors. Moreover, the bill would impose withholding in certain situations where workers fail to provide identification numbers.

B. Safe-Harbor Rule

Five requirements

The bill would establish a safe-harbor test that, if satisfied, results in the classification of an individual as an independent contractor for Federal employment tax purposes. The safe-harbor test would have five requirements, all of which would have to be met for an individual to be treated as an independent contractor under the bill. These requirements relate to (1) control of hours worked, (2) place of business, (3) investment or income fluctuation, (4) written contract and notice of tax responsibilities, and (5) the filing of required returns.

(1) Control of hours worked

The first requirement would be met if the worker controls both the aggregate number of hours worked and also substantially all of the scheduling of those hours. In determining whether an individual controls the scheduling of hours worked, limitations on scheduling would be disregarded if they result from government regulatory requirements, from operating procedures and specifications which have been imposed on the person for whom service is performed (the "service-recipient") pursuant to contract with another party, from coordination of the performance of the service (by persons other than the service-recipient) with the performance of other services, or the control of access to any premises by the service-recipient if the individual controls the scheduling of hours when access is granted.

(2) Place of business

The second requirement would be met if no principal place of business of the worker with respect to the service was provided by the service-recipient. (Accordingly, the requirement would be met if the individual had no principal place of business with respect to the service.) However, the fact that the service-recipient provided a principal

place of business with respect to the service would not cause the individual to fail this requirement if the individual paid a fair rental to the service-recipient.

A special rule would provide that even though a place of business was provided by the service-recipient, it would not be treated as a principal place of business if substantially all the service were performed at some other place of business that is not provided by the service-recipient.

(3) Investment or income fluctuation

The third requirement could be met in either of two ways.

First, the investment or income fluctuation requirement would be met if the worker had a qualifying investment in tangible assets which the individual used in connection with the performance of the service. To qualify, the assets would have to be of significant value in the performance of the service, and the individual's investment in the assets would have to be substantial in light of the nature and amount of the remuneration received for the service. For purposes of this asset investment test, an investment in a vehicle that is used primarily to transport the individual (and any tools, samples, or similar items) would not be taken into account.

Alternatively, this third requirement would be met if the worker risked income fluctuations because more than 90 percent of the remuneration for the performance of the service was directly related to sales or other output (including the performance of services, but not including piecework) rather than to the number of hours worked.

(4) Written contract and notice of tax responsibilities

The fourth requirement would be met if both (a) the individual performed services pursuant to a written contract (entered into before performance of the service) which expressly provided that the individual would not be treated as an employee for purposes of employment taxes, income tax withholding, and certain employee benefit provisions, and (b) the individual was given written notice (in the contract, or at the time the contract was executed) of his or her tax responsibilities for payment of Federal self-employment and income taxes.

The bill provides a special rule for written contracts entered into before January 1, 1983. A pre-1983 written contract would meet the fourth safe-harbor requirement (written contract and notice) if both (1) the contract clearly indicated that the individual was not an employee (e.g., by specifying the individual is an independent contractor) and (2) the notice of tax responsibilities was provided prior to January 1, 1983.

(5) Filing of required returns

This requirement would be met if the service-recipient filed all required information returns with respect to payments made to the worker, unless the failure to do so was due to reasonable cause and not to willful neglect.

Effect on other laws

A relationship which did not satisfy the safe-harbor test under the bill would be classified under common law rules, as if the safe-harbor test had not been enacted.

Qualification as an independent contractor under the safe-harbor test of the bill generally would create no inference with respect to status under provisions of law other than Federal employment tax provisions. However, individuals who qualified as independent contractors under the safe-harbor test for employment tax purposes could not be treated as employees for purposes of tax provisions relating to employer-provided group-term life insurance, death benefits, accident and health benefits, group legal services, educational assistance plans, dependent care assistance programs, and pension, profit-sharing, stock bonus, or annuity plans. This latter rule would not apply in the case of certain pre-1983 services (see discussion of Effective Dates, below).

Nonapplication to certain individuals

The safe-harbor test would not apply to certain agent-drivers or commission-drivers, full-time life insurance salespersons, certain home workers, and full-time traveling or city salespersons who generally are classified under present statutory law as employees for FICA tax purposes.

C. Information Reporting Requirements

Payments of remuneration

The bill would provide a separate Code provision specifically dealing with payments of remuneration for services. Under the bill, a service-recipient engaged in a trade or business who made payments of remuneration in the course of that trade or business to any person for services performed would have to file with the Internal Revenue Service an information return reporting such payments (and the name, address, and identification number of the recipient) if the remuneration paid to the person during the calendar year was $600 or more. Also, the person receiving such payments would have to be furnished with a statement setting forth the name, address, and identification number of the service-recipient, and the aggregate amount of payments made to him or her during the year.

Direct sales

The bill also would provide a new information reporting requirement for certain "direct sellers." The new requirement would apply where a person, in the course of a trade or business, sells consumer products aggregating $5,000 or more to a buyer for resale (by the buyer or any other person) in the home on a buy-sell basis, a deposit-commission basis, or any similar basis as specified in Treasury regulations.[1]

In general, the direct seller would have to file an information return stating the aggregate amount of the sales to such buyer and the name, address, and identification number of the buyer to whom the sales were

[1] A transaction would be on a buy-sell basis if the buyer performing the services were entitled to retain the difference between the price at which he or she purchased the product and the price at which the product was sold as part or all of the buyer's remuneration for the transaction. A transaction would be on a deposit-commission basis if the buyer performing the services were entitled to retain the deposit paid by the consumer in connection with the transaction as part or all of his or her remuneration for the transaction.

made. The direct seller also would have to furnish the buyer with a statement setting forth the name, address, and identification number of the seller, and the aggregate amount of sales to the buyer.

In lieu of so reporting sales of consumer products for resale, a direct seller could elect to be subject, instead, to the bill's reporting requirements for payments of remuneration for services. However, if a direct seller made the election, then the threshold for such reporting would be payments aggregating $50 or more in the calendar year (rather than the generally applicable threshold of $600 or more). Moreover, direct sellers who elected to report payments of remuneration aggregating $50 or more also would be required to file a return setting forth the name and identification number of each buyer with respect to whom they had aggregate sales of $50 or more.

D. Penalties for Failure To Provide Information

Basic penalty

The bill would add a new penalty for noncompliance with the requirements for filing information returns or furnishing statements regarding payments for services or direct sales. The new penalty would be imposed if a person (1) failed to make a required return regarding payments made to another person for services rendered by such other person or regarding direct sales to another person; (2) failed to furnish a statement to such other person regarding such return; or (3) failed to include on any return or statement the entire amount required to be included.

For each failure with respect to an information return or statement regarding payments for services, the penalty would be one percent per month while the failure continued (but not to exceed five percent) of the amount required to be included on the return or statement but not so included. In the case of each failure regarding information returns and statements on direct sales, the penalty would be one-fifth of one percent per month, but not to exceed one percent of the amount not included. The minimum penalty for either type of case (payments for services or direct sales) would be $50. This penalty would not apply if the failure in either type of case was due to reasonable cause and not due to willful neglect.

Penalty surcharge

In addition to the basic penalty described above, the bill would impose a penalty surcharge in the case of multiple violations.

A surcharge of 100 percent of the basic penalty amount would be imposed if the number of failures to file an information return or furnish a statement for a calendar year represented over 10 but not over 20 percent of the total number of returns and statements required to be made by such person for that year. The surcharge would be 200 percent of the basic penalty if the number of such failures was more than 20 percent of the number of returns and statements required. However, no surcharge would apply if the number of such failures for any calendar year was 10 or less, or if the percentage of failures for such year was 10 percent or less.

Statute of limitations exception

The bill would provide a new exception to the general statute of limitations provisions with respect to failures to file information returns or furnish statements of payments for services and direct sales. Under the bill, the Internal Revenue Service generally could not assess the new penalty and surcharge unless it was assessed, or a proceeding to collect it had begun, within six years after the last date (with extensions for filing) for filing the return or statement.

Withholding in certain cases

The bill would provide for withholding of tax at source at a rate of 15 percent if a payee failed to supply an identification number or supplied an incorrect identification number to a person who had to file a return or furnish statements regarding payments for services or direct sales.

If the identification number was not supplied, the payor-filer would be required to begin withholding when aggregate payments to the payee for the calendar year first exceed any threshold requiring the reporting of such payments. If the identification number was incorrect, the payor would be required to start withholding on notice from the Internal Revenue Service that the payee had failed to supply the correct identification number within 60 days after being notified by the Service to do so. Such withholding generally would continue as long as the payee failed to supply or correct his or her identification number.

E. Effective Dates

The safe-harbor test of the bill generally would apply to services performed after the earlier of June 30, 1982, or the date of enactment. However, the written contract requirement would apply only with respect to services performed after December 31, 1982. Furthermore, with respect to services performed after the date of enactment (or after June 30, 1982) and before January 1, 1983, if an individual performing services were treated as an employee, then the safe-harbor test would not apply to those services.

The new information reporting requirements, and penalties for failure to provide information, generally would apply to payments made after December 31, 1982. However, the new reporting requirements for direct sellers would apply only to sales after December 31, 1983.

The new withholding provisions (for failure by a payee to supply a correct identification number) would be effective for payments made after December 31, 1983.

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